RICHARD RUSSELL'S DOW THEORY LETTERS INCORPORATED

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THE MARKET: I guess the key to this market is the old Wall Street adage which states, "News goes with the trend." In a bull market, as I have often stated, "news, almost any kind of news, tends to be interpreted bullishly by the market." Or to put it another way, "all problems in a bull market tend to be resolved positively."

The obvious problem for the market in January was the collapse in the price of oil (see page 3 chart). In the space of three months, oil has dropped over 30% in value. Wall Street had seen nothing like it since the gold smash of 1980 or the market collapse of 1974. The questions: was it bearish? Was the banking system on the verge of collapse and would oil-backed debts the world over go belly up? Or was it bullish, and would the shocking new oil price structure be a boon for the US and the rest of the world's oil users?

Although the final verdict is not in, it would appear that the old Wall Street adage will again be proved right. The market in general appears to like what it sees. The oil news is going with the (bull) trend.

If you want to know what Wall Street thinks, you have to coldly examine the market's price structure. So let's do it. Following the unconfirmed D-J Industrial high of 1565.71 (page 1 chart), the Dow broke down to just above the 1500 level (point A on the chart). But the Transports (at point B) were far from confirming. Following that surprising show of technical strength, the market pushed higher, and on January 24 Wall Street exploded with Industrials up over 18 points and Transports up over 20 points to a new record high. From a Dow Theory standpoint, it now remains for the Industrials to confirm the Transports. This would entail an Industrial close above 1565.71. Will that happen? The odds favor it. Over the last few weeks the market had every chance to fall apart -- and it refused. On Wall Street what won't go down -- goes up.

Events are never crystal clear in the stock market, and I must confess that the Utilities are a puzzle to me now. The same cheap fuel that has spurred the Transports should also prove a boon to the Utilities. So why has the Utility Average been lagging? Are Utilities looking far ahead -- to a booming economy -- and rising interest rates (Utilities are extremely rate-sensitive)? If so, the bond markets should soon confirm this possibility (by declining as rates rise). That hasn't happened yet, so let's sit tight and not jump the gun. It has been said that "the graveyards of Wall Street are filled with the bodies of men who have been right too soon."

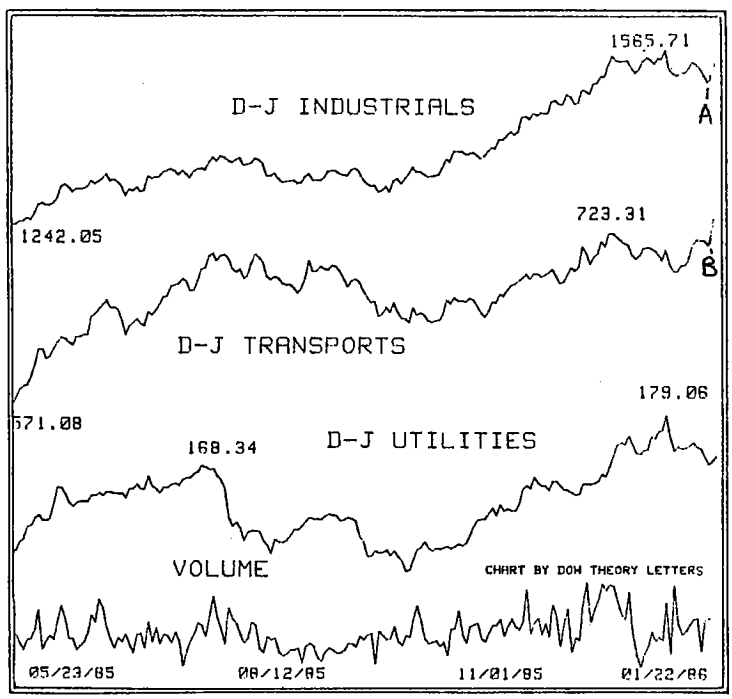
PRICE ACTION: The daily chart (top of page 2) shows the path of the Dow and its 144-day exponential moving average from late 1983 to date. The relationship of the Dow and its moving average (MA) can tell us a lot about what happened and what we might look for in the period ahead.

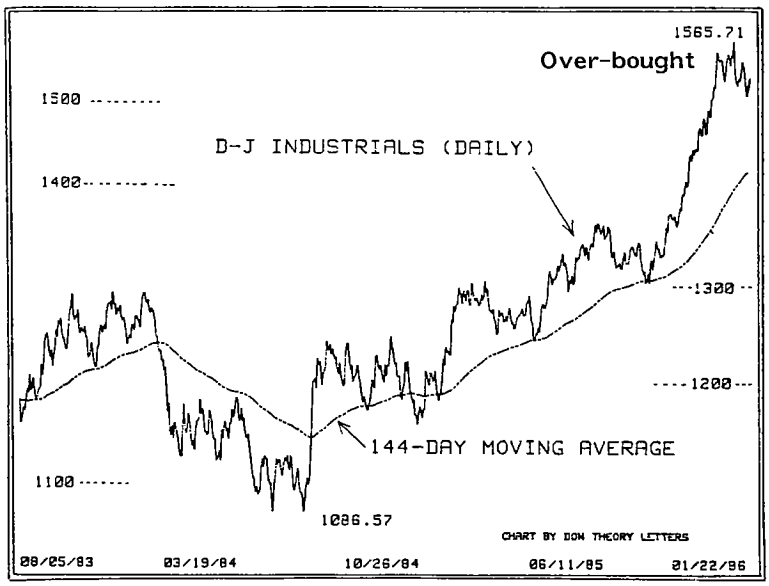
The 144-day MA obviously tends to follow the Dow -- but with a lag time. Since the MA tends to filter out all sharp fluctuations, it shows on the chart as a smooth line that rises or falls (gradually) as it follows the Dow.

Normally, the Dow will never move too far away from the MA -- either on declines or advances. From this standpoint, you might picture the Dow as being attached to the MA by a rubber band, a band which exerts continuous pressure to pull the Dow back toward the MA.

The January rise took the Dow to a closing high of 1565.71. At that point the Dow was a big 169 points above its MA, the widest spread in recent years. The normal consequences of this kind of upside exuberance would be a snap back to or even below the MA (which now stands at roughly 1400). In other words, the normal expectation following a 169 spread in the Dow and its MA would be a correction, and you can see this same action repeatedly on this chart.

A test is now on for the Dow (and the market), and we should be able to judge the inherent strength of the market during the course of this test. In a continuing, strong primary bull market it would be normal for the Dow to come down and test its MA, maybe even penetrate it temporarily as it did during the first half of 1984. That's one phenomenon we can watch for.





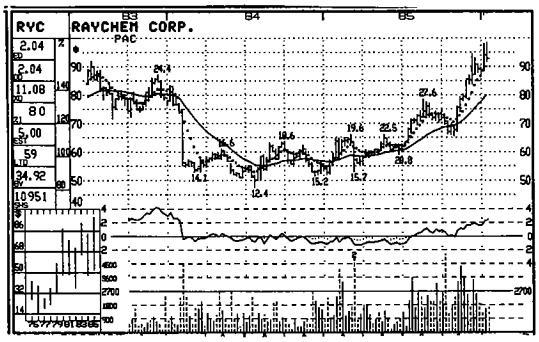
In a super-strong bull market we might expect the Dow to consolidate at a high level, say at 1500 to 1550 in the present situation -- while the MA line rises to meet the Dow. Such action, if it occurs, will take time, maybe a few months or so. But if the Dow can hold at a high level (as it has been doing) while the MA climbs to meet it, that will be a most impressive show of strength. Such "corrective consolidation" could last a while, and it will elicit yawns of boredom from those who don't realize what is happening.

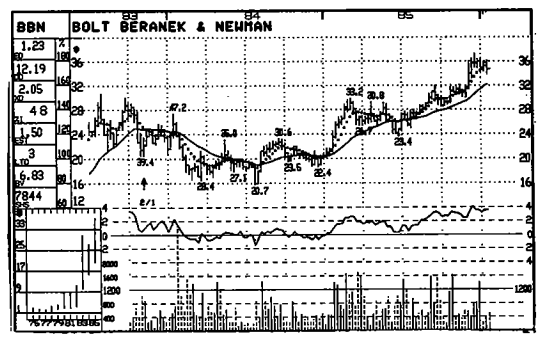
But I am writing this because I want subscribers to be able to judge the action of the market in the period ahead. And I think this piece should help you to understand what could be occurring.

INVESTMENT POSITION: No Dow Theory bear signals at this time, and the PTI is holding well above its 89-day moving average. So the bull stays firmly in this box. The implications of the collapse in oil prices are so complex that it would be best to let the market tell its own story. Following the initial panic action of January 7 and 8, the market has taken the whole oil phenomenon in stride including the slide in the oil stocks themselves as well as the sharp break in many major bank shares. From what I have seen so far of the January market action, I would say, "Sit tight with all positions in both stocks and bonds," And I like particularly the action of the Transportation Average which so far has negated any bearish action on the part of the Industrials.

I have been eyeing the action of one stock, Raychem on the NYSE. The stock acts WELL and is near its all-time high. RYC is on the cutting edge of all kinds of new materials and new technologies, many of which are used by the military. This stock is selling at a high P/E, but despite that it is a stock that should probably be in every subscriber's portfolio.

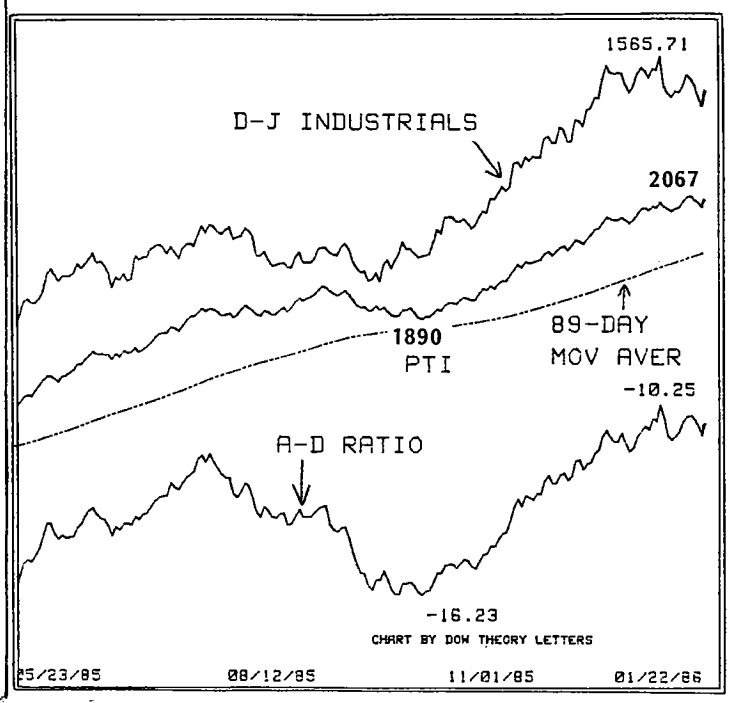
A few years back I recommended a package of military-oriented stocks. The package as a whole turned out to be only fair, but two stocks bailed out the package and produced an overall profit: Bolt, Baranek (BBN-NYSE) and BDM (Amex). I still like these two exceptional stocks. Over the longer term I like the following, all three being positioned for the 1990s, BNN, BDM and RYC. They should be bought as a package. Charts below courtesy Mansfield.





SAFE: Many people (including, believe it or not, a few of my subscribers) are worried about what happens after today's bull market has breathed its last.Frankly, I don't know, and neither does your broker or President Reagan (or Regan) or the Brookings Institute or anyone else. My good friend, Bob Prechter, who predicted what we are seeing now (in his Elliott Wave Theorist) states that after this bull market has breathed its last we will see the worst bear market in American history.

If Bobby P. is correct, most of what you and I own today will be selling (to put it mildly) at bargain-basement prices. So how in the world can we



be safe? I don't know the ulitmate answer to that question (personally, I just diversify). But I do know the single safest investment in the US (and by the way, an investment is something that pays a return, as opposed to gold, for instance, which is true money and does not pay a return).

The safest investment in the US today is the preferred stock of the largest closed-end investment company in the nation, and I'm talking about the preferred stock of the Tri-Continental Corp. Tri-Continental (TY on the NYSE) has been around for over 57 years. It holds a portfolio of over $1.3 billion in high-grade common stocks and bonds. TY has no bonds or debt outstanding against it. But aside from its common shares, TY has a small issue(752,740 shares) of cumulative preferred stock callable at 55 . The preferred pays a dividend of $2.50 a year so that the total expense to TY for its preferred (per year) is a mere $1.87 million. Since the total investment income from TY (from all its common stock and bonds) runs around $50 million per year, it is obvious that the little TY preferred issue has an absolutely enormous coverage.

On top of that, since this is a cumulative preferred issue, if for any reason TY's total income dropped below $1.8 million (an almost unbelievable situation) then the missed dividends on the preferred would accumulate and be paid when earnings for the company picked up again.

There is only one other closed-end company with a cumulative preferred, and this is Source Capital Inc. (SOR on the NYSE). SOR has net assets of $253 million. There are 2 million shares of Source cumulative preferred (each share pays $2.40) so that the preferred costs SOR $4.8 million a year. But SOR has a net investment income of $16 million, so the preferred is well-covered (not covered as well as TY but still well-covered). SOR has no bonds against it, so that all its investment income goes first to the preferred and then to the common.

These two closed-end companies offer a totally unique investment in their cumulative preferred stocks (both preferred listed on the NYSE). You have the following advantages when buying the preferred of TY and SOR: (1) a diversified high-grade portfolio of stocks throwing off dividends, but that income going FIRST to the preferred holders. (2) Big coverage on the preferred dividends. (3) The preferreds are both cumulative so that any skipped dividends will be paid at a later date.

By the way, for those who don't know, the closed-end trusts differ from mutual funds in that when you buy a closed-end stock you are buying that stock from another investor who is selling (in the same way as when you buy shares of GM). On the other hand, when you buy a mutual fund your money goes to that fund and the fund issues you a certificate saying that you own the shares. Thus a mutual fund's total assets increase with new buying, while a closed-end fund's assets don't change at all when you buy those shares from someone else.

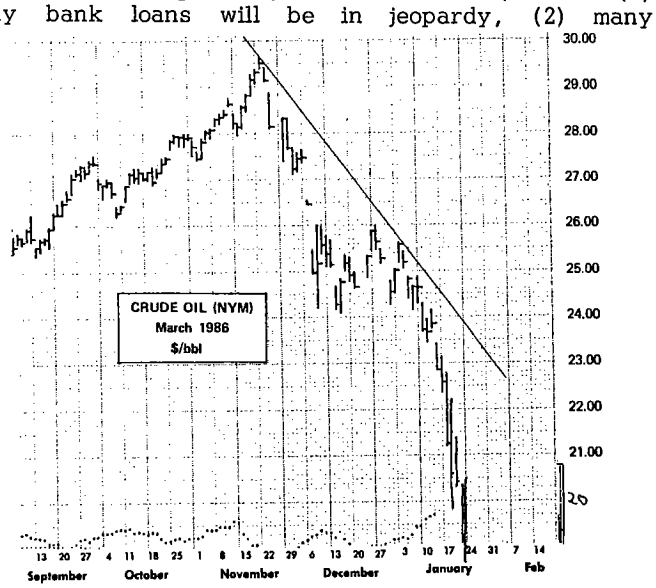
Why are closed-end funds not as well-known as mutual funds? Simple, they are not advertised. A mutual fund can increase its assets by bringing in new investors via advertising. A closed-end fund gains nothing when you buy its shares on the NYSE.

By the way, for those subscribers who want a very simple investment program, you can do it all by simply putting half your new money into SOR or TY common stock and half into SOR and TY preferred. Anyone who did this over the course of a lifetime would probably be FAR ahead of the average investor. As a variation, the wealthy investor (high tax bracket) might put half into TY or SOR common and the other half into high-grade muni bonds.

There are many closed-end funds listed on the NYSE, and a few others that I like are Adams Express, Lehman Corp and General American Investors. I have recommended all of these in the past, and many of my older subscribers own large quantities of these closed-end trusts.

EVENTS: On January 21 oil prices caved in with crude oil (spot contract) actually dropping below the $20 a barrel support level. By January 23 the crude actually dropped temporarily into the $18 area, but at this point the oil crash had the appearance of exhaustion on the downside (see chart).

On the face of it, the oil drop is deflationary. I've said many times that if oil caves in, then many who have complained about the high price of crude might have new (and very serious) things to worry about. Remember, the $30 plus oil price has been built into the world economy. Now, with oil in the $20 area (1) many bank loans will be in jeopardy, (2) many



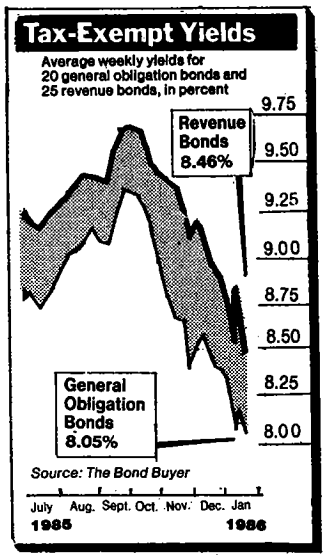
oil-producing countries will find paying their debts almost impossible -- particularly Mexico, and (3) nobody mentions this but the fat tax income to the US treasury via the "excess profits tax" on oil will almost disappear. This will push the US deficits much higher!

Gold, which could be expected to cave in with oil (because of the deflationary implications), acts remarkably well. Why? Because gold is where you go when the banking system looks shaky or when you don't trust paper money. And with oil (which is collateral for billions of dollars in bank loans) down in the cellar, no one is sure how the banks are going to come out.

Meanwhile bonds have also acted quite well in the face of the oil collapse and the gold rise. The good bond action is probably a reflection of the Gramm-Rudman and a try at deficit reduction. My feeling is that public consciousness of the urgent need for deficit reduction is now (finally) so strong that Congress and

the President have been backed against the political wall. The cry from the public is "Do something!" Gramm-Rudman is Congress's answer which is, "We won't do anything ourselves, but maybe a faceless, anonymous law will."

In the bond area, I've been saying for almost two years that the biggest yield bargains around were the muni bonds. Evidently, informed investors agreed. This yield chart shows what has occurred to munis since mid-1985. As the yields decline, of course, the price of the bonds goes up.



TRAVEL? I hate to travel. I hate the late planes, the baggage mix-ups, the heavy airline food, the jet lag, the leg cramps, etc. I also detest living out of hotel rooms and being ripped off as a tourist in a foreign land. OK, just put me down as a grouch. Most of the world loves to travel, and they're undoubtedly right.

Harry Schultz wanted me to speak at Monte Carlo in June and being a travel-phobe I begged off. But don't follow my example. There are two fine overseas seminars being given this spring: the first in Lausanne via ISI (June 15-22) and the second in Monte Carlo (June 22-26). At Monte Carlo my old buddy, Harry, will be on stage solo for two full days, and there will also be other fine speakers. For full info write to HSL, Box 381, CH-1001, Lausanne, Switzerland or ISI, 1859 Main St., Sarasota, FL 33577.

Second Item: Here's a picture of Harry Schultz and Russell (right) taken against a wall in the gaslight section of Vancouver last summer (by the way, I love Vancouver). No there's nothing significant about the fact that we're "against the wall." Actually, I think we were both recovering from speeches we had given an hour earlier. This will (hopefully) be your last view of me for 1986 -- but watch for all-new pics in 1987.

NOTICE: About 20 years ago, I published two chart books, one book contained the Dow and the A-D Ratio (daily) from 1931 to date. The second contained charts (daily) of the D-J Industrials, Transports, Utilities, 20Bonds and NYSE volume from 1885 to date. Major events of historical or financial interest are noted on the Averages page. Both albums include one large (11"x17") page for each year. The albums are three-hole punched, and pages are published for each new year (price for the new pages are $2 for each album).

I now offer the new 1985 pages at $2 each for those who want to update their albums. I also offer Xerox copies of the complete albums at $95 for the A-D Ratio album and $135 for the album of the D-J Averages (both post-paid). These volumes are invaluable for serious investors; they offer an unmatched historical guide to anyone who wants to know what happened at any day, week or month going back through the years. There is nothing like these albums on the market, and in due time they will become collector's items. Important: Please make all checks out to Richard Russell.

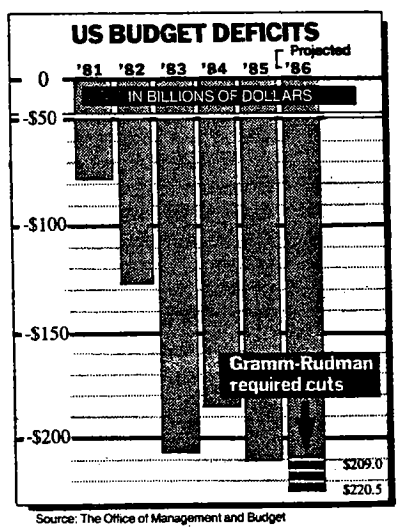
NOTES & QUOTES: Had another long talk with military expert Mel Lippman of US Organization Chart Service of La Jolla.Lippman totally pooh-poohed any thought of trading away Star Wars in any kind of agreement with Russia. Lippman made the following points: (1) By early 1990s Star Wars (SDI) will be a full arm of the US military in the same way as the Navy, Army or Air Force are today. (2) The SDI is getting first priority on all funds. (3) General Abrahamson (who heads SDI) reports directly to Secretary Weinberger. (4) The future of the US military is in high-tech, and SDI is the cutting edge of the high-tech military revolution. "And if you think we're going to trade that away, dream on!"

* *

If you're a man, if your body is warm, and if you're still sane -- then you're a hot commodity. The reason: men don't tend to live as long as women, and men re-marry more frequently than women after divorce. Result: a man shortage. Consider this: In 1980 widows outnumbered widowers 6 to 1! Divorced men 45 to 64 years of age are four times as likely to re-marry as divorced women! There is an ever-increasing pool of women over 25 -- without potential marriage partners. "Yeah," said my wife, Faye, "and don't you guys know it!"

* *

The Gramm-Rudman deficit cuts are off and running, and government departments are screaming as expected. Each department announces that its "empire" is absolutely essential for the survival of the US,and that furthermore, the cuts will destroy the department. Of course, this is patent nonsense, and if I had my way some whole departments would be jettisoned. Furthermore, I am reasonably certain tens of billions of dollars can be safely sliced off the military budget. The waste and duplication in the military is almost beyond belief.



At any rate, if you think Gramm-Rudman is tough now, glance at this chart showing the federal deficits

since 1981. The little blip at the bottom of the 1986 deficit shows the amount that is to be lopped off during the first year of G-R. Can you imagine what will happen when the real cuts start in 1987 (if we ever get that far)?

* *

Parade magazine recently presented its best and worst news of the year. The following took the prize as the "Worst Travel News of 1985":

Nigerian soldiers, faced with sorting out the problem of an internal Nigerian Airways flight that had been three times overbooked, insisted that all passengers with boarding cards should run around the aircraft twice—with the fastest qualifying for seats.

This took the prize as the "Best Celebrity Answer of 1985":

William F. Buckley Jr. was asked, during a fund-raising speech for Rep. Jack Kemp (R., N.Y.), what White House position he would seek if Kemp were elected President. Replied Buckley: "Ventriloquist."

* *

A leading advocacy professor at Columbia Law School calls this his "Rule No. 7 of the art of persuasion." Here's the rule as expounded by Prof. Jerome Michael: "These are my final words on your advocacy. If you have the facts on your side, hammer the facts. If you have the law on your side, hammer the law. If you have neither the facts nor the law, hammer the table!" Remember those words next time you're on jury duty.

* *

Foreign bonanza: You and I can't do it but foreigners can? Do what? Buy US corporate BEARER bonds which allow them to take in interest tax-free and also allow them anonymity as well! The federal tax-exemption was granted in the summer of '84. Why? Because the US wants to encourage foreigners to buy all they can of US debt. The US is now a principal tax-haven for foreign tax cheats. In other words, it doesn't bother the US Congress to help foreigners to cheat on their taxes as long as they put their yen, marks and francs in the US!

* *

My favorite Ibsen quote: "The strongest man in the world is the man who stands most alone." It works with the markets too.

* *

GOLD, OIL: Question: Russell, you've been telling us to get on a gradual gold-buying program ever since mid-1985. Then in the last Letter you said that gold was turning more bullish and that you had bought a larger batch of gold coins. What's going on?

Answer: The US is now facing one of the most difficult economic situations in its history. We've got a fat and juicy standard of living, we feel very good about ourselves, and our boys and girls coming out of college all want to be rich businessmen (rather than scientists, educators or engineers). In the meantime, our manufacturing and productive abilities are going down the drain. When you go to the stores almost everything you see is manufactured somewhere else: cars from Japan (and now Yugoslavia), shirts from South Korea, underwear from China and on and on.

Americans have decided that they want to do the "clean" things like banking, advertising, making TV movies, real estate brokerage. The dirty jobs like making steel, building cars, building ships, those jobs we can relegate to the Asian countries where labor is cheap and plentiful and workers don't mind putting in a 50 or 60 hour week.

There's only one problem. It's called a balance-of-payments deficit. And those BOP deficits are running around $150 billion a year -- against the US. In the early 1900s this kind of BOP deficit would have set off an immediate run on the dollar. Foreigners would have demanded gold for their dollars, the price of gold would have rocketed and the value of the dollar would have collapsed.

Why isn't the same thing happening today? For one thing, the dollar is now the world's reserve currency. Nations count their reserves in terms of two items: (1) dollars, and (2) gold. Dollars pay a return and gold does not. So nations hesitate to swap too many dollars for gold. (3) Another factor is that of the world's democracies, the US is the safest. We are the only militarily strong democracy and we have a long history of freedom. Foreigners feel that their money is safe here. (4) A fourth item is interest rates. US interest rates are high and attractive compared to most of the other industrial nations, and those high interest rates (particularly on US Treasury paper) are an incentive to keep the dollar here.

Nevertheless, we know that ultimately when any economic situation gets out of whack for a long enough period of time -- the piper must be paid. The US cannot continue to live in a fool's paradise, consuming more, borrowing more, living better than the real producers -- and all because foreigners are willing to buy US debt and live with huge US balance-of-payments deficits. No, sooner or later the piper will be paid. It will be paid in one of the following ways:

(1) An old-fashioned US depression, in which salaries fall, workers look for jobs instead of pay boosts, and industry becomes very competitive again. This, of course, is the classic cycle of capitalism.

(2) A run on the dollar with the value of the dollar caving in and gold booming as investors panic out of dollars and into foreign currencies and gold.

(3) A third possibility is US interest rates going through the roof as the Fed attempts to make dollars too attractive to sell. Of course, towering interest rates would probably bring down the US economy much as they did during 1982 (even though, at that time, gold remained in its bear market).

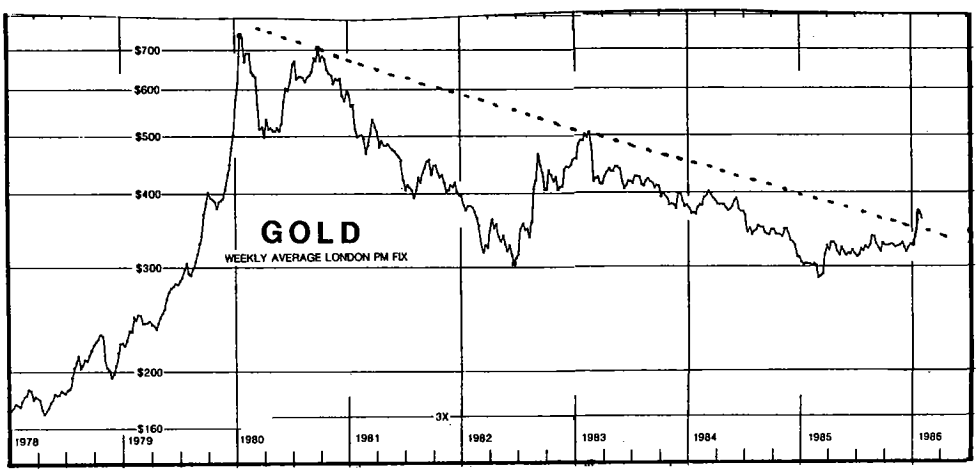
Some additional comments here. Gold may be purchased for two basic reasons: (1) an island of safety during financial chaos or in the event of a collapsing banking system, and (2) as a hedge against inflation, during which time investors move into real money (i.e., gold) and out of fiat or paper money.

There are a number of complicated cross-currents in the gold picture at this time. On the bearish side are (1) the overall deflationary forces of debt, and particularly US debt (which is acting as a gigantic sponge, sopping up liquidity as fast as it can be produced). Then there is (2) the deflationary force of declining oil prices, as well as (3) the deflationary effect of vicious foreign (Asian) competition for US markets.

On the bullish side (for gold) of the ledger are (1) the horrendous US balance-of-payments deficits, deficits which will erode the dollar's value. (2) The temptation by the Administration and the Fed to

monetize away the mountain of US debt, which is almost unsustainable under the current stagnant economic conditions. (3) Finally, there is the possibility of trouble in the banking system, and such trouble could easily set off a stampede for real money (i.e., gold).

Speaking of trouble in the banking system, it is well-known that many of the oil-producing nations are also big debtor nations, and declining oil prices will make it almost impossible for these nations to service their debts. Also, many banks have made big loans based on high-priced oil as collateral. As oil declines in price, these loans become shaky.



Speaking of oil, experts in the field have been warning of lower prices to come for almost two years. And oil prices mocked the experts by climbing during much of 1985. But as the old adage runs, "the market always does what it's supposed to -- but NEVER WHEN." So just about the time the experts had crawled into their shells, the price of oil started coming unglued.

GOLD ACTION: When judging trends, I invariably prefer semi-log or ratio charts to simply arithmetic charts. Ratio charts deal with percentages of rise or fall or "growth trends" as they are sometimes called. This chart of gold covering the action of gold over the last eight years is probably the most basic and most important chart in the gold picture (chart by Deliberations, PO Box 182, Adelaide St. Stat., Toronto, Ont., Canada M5C 2J1).

What we see here is a ratio chart showing the explosive bull market rise in gold from 1978's (weekly average) price of 175 to the final top recorded in early 1980 with a London fix of over 700 on the weekly average. From January 1980 on we see a vicious bear market in gold, a bear market which took the average weekly price well under 300 (actual London low fix was 284.25 recorded in February 1985).

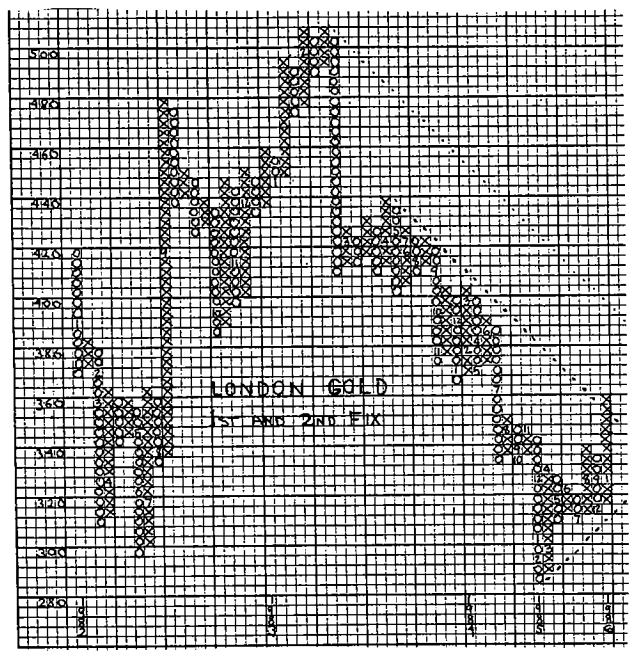
On January 16, 1986 gold shot up above the 360 level, a level I have been talking about for many months. What this move did was reverse the five-year declining (bear market) trend of gold. Thus, the Jan. 16 rise was, in my opinion, a major bull signal for gold. This is confirmed by the accompanying point & figure chart. Gold has now reversed an important downtrend line.

In recent reports I stated that it was significant that gold, almost a year after its bear market low of 284.25 (Feb. 25), had refused to penetrate the bear market low point again. As a rule, once a bear market low is established, the LONGER the time elapsed without another penetration, the more the odds favor a turn in the major trend. January 1986 marked the 11th month that gold had held above its bear market low. On that action alone I had suspected that the bear market was over. So from here on I would take any dip, sell-off or correction as a counter-trend movement in a new gold bull market. And subscribers should act accordingly.

My point & figure chart now clearly tells the story. The recent advance to the 360 box was doubly significant because (1) the move bettered the preceding rally peak at the 340 box, and (2) because the advance reversed the declining trendline from the April 1983 peak. But investors often regard an initial rise following a long, discouraging bear market as a "mistake" or as a meaningless, emotional "pop." But the January gold rise did establish an important market point at the 360 box.

Now I would say that any further rise that would take gold to 364 (i.e., a breakout above the 360 box) would have extremely bullish implications. Such a move would probably set off broad gold buying on the part of professionals.

NEXT MAILING: February 12



LATE NOTES: One of the mysteries we might mull over now is why gold has been moving up while silver languishes, a phenomenon which has produced an extraordinary gold/silver ratio of 58 to 1. If it was just a matter of inflation, then all the metals and most of the commodities would be rising. But that's not happening. My guess: it's the balance-of-payments problem, which reflects weak US economic capabilities versus increasingly tough foreign competition. "How long can the dollar hemorrhage go on?" is what the gold move is probably saying. ... OOPS: Page 6, last Letter, symbol for Skylark (gold) is SKR (Vancouver), not SRR.